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Supreme Court, U.S.
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IN THE
Supreme Court of the United States

VISION SERVICE PLAN,
Petitioner,

v.

THE UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

Jeffrey L. Fisher
Douglas C. Ross
Marvin L. Gray, Jr.
DAVIS WRIGHT TREMAINE LLP
Suite 2200
1201 Third Avenue
Seattle, WA 98101
(206) 622-3150

Thomas A. Fessler
VISION SERVICE PLAN
3333 Quality Drive
Rancho Cordova, CA 95670
(916) 851-4889

Kenneth W. Starr
Counsel of Record
KIRKLAND & ELLIS LLP
777 South Figueroa St.
Los Angeles, CA 90017
(213) 680-8440

Susan E. Engel
KIRKLAND & ELLIS LLP
655 Fifteenth St., N.W.
Washington, DC 20005
(202) 879-5000

Counsel for Petitioner

QUESTION PRESENTED

Consistent with the IRS's longstanding position and Congress's intent, whether a nonprofit health care organization that provides benefits to a broad and substantial class of subscribers qualifies for tax exemption as a "social welfare" organization pursuant to section 501(c)(4) of the Internal Revenue Code of 1986.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioner states that it has no parent companies and no publicly owned company owning 10% or more of its stock.

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JURISDICTION

The court of appeals entered judgment on January 30, 2008. On April 9, 2008, the court denied a timely petition for rehearing and suggestion for rehearing *en banc*. App. 26a. On June 19, 2008, Justice Kennedy extended the time for filing this petition to and including August 7, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The most directly pertinent portions of section 501 of the Internal Revenue Code of 1986 provide as follows:

> (a) EXEMPTION FROM TAXATION
>
> An organization described in subsection (c) or (d) or section 501(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.
>
> ...

(c) LIST OF EXEMPT ORGANIZATIONS:

The following organizations are referred to in subsection (a):

...

(3) Corporations ... organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or [for certain other purposes, and within limitations on political activities and private inurement].

(4)(A) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare ... and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

...

(m) CERTAIN ORGANIZATIONS PROVIDING COMMERCIAL-TYPE INSURANCE NOT EXEMPT FROM TAX

(1) DENIAL OF TAX EXEMPTION WHERE PROVIDING COMMERCIAL-TYPE INSURANCE IS SUBSTANTIAL PART OF ACTIVITIES

An organization described in paragraph (3) or (4) of subsection (c) shall be exempt from tax under subsection (a) only if no substantial part of its activities consists of providing commercial-type insurance.

...

(3) COMMERCIAL-TYPE INSURANCE

For purposes of this subsection, the term "commercial-type insurance" shall not include —

(A) insurance provided at substantially below cost to a class of charitable recipients,

(B) incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations;

....

Code sections 501(a), 501(c)(3)-(4), and 501(m), are set forth in their entirety at App. 27a-30a.[1]

The term "social welfare," used in section 501(c)(4), is not defined in the Code. Treasury Regulation § 1.501(c)(4)-1(a)(2) provides in part:

(i) *In general.* An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated

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[1] In this petition, all references to the "Code," and all statutory citations that do not include the United States Code title, are to the Internal Revenue Code of 1986, as amended.

> primarily for the purpose of bringing about civic betterments and social improvements.

The entirety of Treasury Regulation § 1.501(c)(4)-1, which is the only regulation addressing section 501(c)(4) of the Code, is set forth at App. 30a-32a. No regulations have been issued under section 501(m).

STATEMENT OF THE CASE

This case presents a critically important, recurring question regarding the standards governing the tax-exempt status of nonprofit health care enterprises, particularly nonprofit health maintenance organizations (HMOs). Under the common law, which this Court has held is reflected in section 501(c) of the Internal Revenue Code, nonprofit health care organizations are deemed "charitable" entities that promote the "social welfare," and are thus entitled to tax-exempt status, as long as the class of subscribers is not so small that the public benefits are insubstantial. Consistent with the common law, the IRS has long taken the position that nonprofit HMOs, including petitioner Vision Service Plan (VSP), are eligible for tax-exempt status. Indeed, the IRS granted VSP a tax exemption in 1960.

Without any change in statutory or regulatory law, and without any change in the operations of VSP, the IRS overturned its longstanding position, revoking VSP's tax exemption in 2002. According to the IRS, a nonprofit health care organization that limits its benefits to a class of subscribers is no longer eligible for tax-exempt status, unless it also provides some as-yet-unquantified, unspecified

amount of "community benefits." By condoning the IRS's unfounded departure from the common law in a cursory, unpublished decision, the Ninth Circuit has cast tax exemption law into turmoil, introducing unprecedented uncertainty in a nonprofit industry that relies on tax exemptions in order to fulfill its basic mission of providing health care for the benefit of the community to all applicants. Indeed, the Ninth Circuit's ruling calls into question the tax exemptions for all nonprofit health care organizations, including not just otherwise qualified health plans and HMOs, but also hospitals, nursing homes, and others.

This is directly contrary to Congress's clearly expressed intent. In 1986, Congress struck a balance in determining which nonprofit health care organizations should be exempt from taxes. Section 501(m) of the Code denies a tax exemption to "charitable" and "social welfare" organizations (*i.e.*, section 501(c)(3) and (4) organizations) that offer "commercial-type insurance," such as Blue Cross and Blue Shield. At the same time, however, section 501(m) acts as a savings clause, expressly preserving the existing tax exemption for nonprofit HMOs that do not offer commercial-type insurance. Because nonprofit HMOs are, by their very nature, organizations that provide benefits to a class of subscribers, the IRS's position therefore contravenes Congress's determination that these entities should be eligible for tax-exempt status.

The standards governing the availability of tax exemptions to nonprofit organizations in the health care field is an important issue of federal law that has not been, but should be, decided by this Court.

Because of the billions of dollars involved in this industry and the potentially adverse impact on public health and the cost and availability of health care, the issue should not await the development of a conflict in the circuits. More than enough confusion and uncertainty exists already.

A. The Petitioner, Vision Service Plan.

VSP is a California nonprofit corporation established in 1955 and licensed under California's Knox-Keene Health Care Service Plan Act of 1975 (Cal. Health & Safety Code § 1340 *et seq.*). VSP offers only a single service: vision care. It provides prepaid medical service plans, primarily covering eye examinations and corrective lenses, that deliver services through a network of private practice optometrists and ophthalmologists. VSP contracts with these providers at a discount from their usual and customary rates.

In 1960, the IRS recognized VSP's tax-exempt status under section 501(c)(4). VSP's organization and operations have not changed in any material way since that time, except that it has grown significantly in size and thus serves ever broader portions of the community. Beginning in 1960 as a regional provider, VSP along with its affiliates has become a national provider of vision care.

As a nonprofit entity providing care to a large segment of the community, VSP pursues a goal of maximizing delivery of health care services within the limits of its financial capacity, rather than maximizing net income:

- in 2003, the tax year in question, VSP had over 6 million enrollees, more than 40% of whom were poor or elderly beneficiaries of Medicaid, Medicare, or similar state programs;

- VSP provides millions of dollars in free vision services to uninsured or underinsured children and victims of disasters;

- even for those subscriber groups who participate at full rates, VSP has negotiated discounts with its contract providers of 20% or more off the providers' usual and customary rates, with even deeper discounts for services provided to Medicare and Medicaid patients;

- over a third of the providers in VSP's network are in medically underserved communities;

- VSP has no blackout provisions on enrollment and no limitation for pre-existing conditions;

- VSP has a substantial program of community outreach and patient education on the health benefits of annual comprehensive eye examinations;

- VSP uses its accumulated surplus and reserves for the purpose of providing a business safety net and improving the cost effectiveness and quality of the eye care services it provides;

- no part of VSP's net revenues or assets can inure to any private person or be distributed as dividends; VSP's by-laws preclude such inurement; and

- VSP's Articles of Incorporation affirm its nonprofit business model: the Articles require that if the organization dissolves, its remaining assets are to be distributed "to an educational, research, scientific or health institution, organization, or association to be expended in the advancement of the science and art of optometry."

Thus, in contrast to for-profit commercial insurers, VSP is not investor-owned, and it provides benefit plans to subscribers without regard to traditional insurance risk analyses (*i.e.*, pre-existing conditions for profit underwriting guidelines). Despite these stark differences, in 2002, the IRS determined that VSP should be taxed as if it were a for-profit commercial insurer. The IRS revoked VSP's tax-exempt status, prospectively, on the ground that it was not "operated primarily for the promotion of social welfare." Neither in 2002 nor in the course of discovery and argument did the IRS contend that VSP's operations had changed since 1960 when the IRS granted VSP a tax exemption.

VSP paid taxes for 2003 and sued for a refund in the United States District Court for the Eastern District of California. The District Court had jurisdiction under 28 U.S.C. § 1346(a)(1).

B. The Proceedings Below.

1. The District Court granted summary judgment for the government. The District Court determined that VSP is not eligible for a tax exemption because "VSP's primary purpose is to serve VSP's paying members." App. 14a. The District Court recognized that "VSP does provide

services through charity programs," but it concluded that "these services to non-enrollees are not, comparatively, substantial...." App. 14a. In the District Court's view, "VSP is operating primarily for the benefit of its subscribers rather than for the purpose of benefitting [*sic*] the community as a whole." App. 18a.[2] The District Court thus would deny 501(c)(4) tax-exempt status to any HMO that limits its benefits to a class of subscribers, no matter how large that class.[3]

2. The Ninth Circuit affirmed. That court gave VSP's appeal short shrift. In a memorandum decision, it stated, without analysis, that VSP is not eligible for tax-exempt status because its "primary purpose" is to "benefit[] VSP's subscribers rather than the general welfare of the community." App. 2a. The Ninth Circuit recognized that "VSP offers some public benefits," but concluded that VSP's

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[2] The District Court also found that VSP's primary activity was "carrying on a business with the general public in a manner similar to organizations which are operated for profit." App. 23a (quotations omitted). The Ninth Circuit expressly refused to reach this issue. App. 3a.

[3] The District Court also seemed to conclude that VSP is not an HMO because it arranges to provide health care services through contract physicians rather than providing the services through physician employees. App. 15a. While the Ninth Circuit did not address this point, the District Court's conclusion is clearly erroneous. Both the IRS and this Court have recognized that "HMOs directly provide *or arrange for* the provision of health care services to members on a prepaid basis." Internal Revenue Manual § 4.76.31.2(1) (emphasis added); *see also Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355, 367 (2002) (the "defining feature of an HMO is receipt of a fixed fee for each patient enrolled under the terms of a contract to provide specified health care if needed") (citation omitted).

subscriber-based structure precluded it from finding that those benefits are "enough for us to conclude that VSP is primarily engaged in promoting the common good and general welfare of the community." App. 2a (emphasis removed). The court did not explain why VSP's "subscribers" were not a sufficiently large body that the promotion of their health care was of benefit to "the common good." Nor did the court explain how its decision could be squared with the common law or the IRS's previously-held position that health care itself is a mission that benefits social welfare.

REASONS FOR GRANTING THE PETITION

I. The Decision Below Conflicts With Longstanding Common Law Principles And Congress's Intent To Preserve Nonprofit HMOs' Tax-Exempt Status.

The Ninth Circuit's decision turns on the premise that an HMO providing health care to a broad but limited class of patients, *i.e.*, less than all members of the community, does not qualify for a 501(c)(4) exemption. This is directly contrary to the common law of charitable trusts, which this Court has held guides interpretation of the Code's charitable exemptions, and which provides that health care is a "charitable" purpose. It is also in conflict with Congress's 1986 judgment that nonprofit HMOs *are* entitled to tax-exempt status. If allowed to stand, the Ninth Circuit's decision will allow the IRS to proceed on an uncertain and unprecedented course, stripping HMOs of a tax-exempt status that enables these organizations to

fulfill their basic, "charitable" mission of providing health care.

1. Tax exemptions for nonprofit "charitable" and "social welfare" organizations have been part of federal income tax law at least since the Revenue Act of 1913, Pub. L. No. 63-16, § 2(G), 38 Stat. 114, 172. These terms are not defined in the statute. However, this Court has observed that the "common law of charitable trusts" should guide interpretation of the "charitable exemption and deduction sections" of the various tax laws. *Bob Jones Univ. v. United States*, 461 U.S. 574, 588 n.12 (1983), *citing, e.g.*, H.R. REP. NO. 91-413, pt. 1, at 43 (1969) (describing "charitable" as "a term that has been used in the law of trusts for hundreds of years"). Similarly, Treasury Regulations provide that "[t]he term 'charitable' is used in section 501(c)(3) in its generally accepted legal sense." Treas. Reg. § 1.501(c)(3)-1(d)(2).

The common law of charitable trusts leaves no doubt that the promotion of health is in itself a charitable purpose.[4] This is true regardless of the percentage of needy patients: relief of poverty is a possible, but not essential, object of "charity." IV-A WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 372 (4th ed. 1989). Moreover, the charitable character of a health care institution is not lost simply because patients pay for the care that they receive.[5] Nor is

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[4] *See, e.g.*, 2 RESTATEMENT (SECOND) OF TRUSTS § 372, comment *a* (1959); GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 374 (2d ed. rev. 1991); IV-A WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 372 (4th ed. 1989).

[5] *See, e.g., Butterworth v. Keeler*, 219 N.Y. 446, 449, 114 N.E. 803, 804 (1916) (Cardozo, J.) ("What controls is not the receipt of income, but its purpose."); RESTATEMENT § 372

the charitable character of the institution lost simply because its subscribers are limited to fewer than all members of the community, provided that the number of subscribers is not so small as to be of no practical benefit to the community. 2 RESTATEMENT (SECOND) OF TRUSTS § 372, comment *c* (1959) (hereinafter "RESTATEMENT"); *id.* § 375; GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 365 (2d ed. rev. 1991); SCOTT ON TRUSTS §§ 372, 375.

Under the common law of charitable trusts, therefore, VSP is a charitable entity even though the entire public does not participate in VSP's prepaid vision service plans. As the Tax Court held in one of the earliest HMO tax exemption cases:

> To our knowledge, no charity has ever succeeded in benefiting every member of the community. If to fail to so benefit everyone renders an organization noncharitable, then dire times must lie ahead for this nation's charities.

Sound Health Ass'n v. Comm'r, 71 T.C. 158, 185 (1978), *acq.* 1981-2 C.B. 1. If the rule were otherwise, well-known and highly respected nonprofit HMOs could lose their tax exemptions, as could many nonprofit hospitals.[6]

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comment *c*; BOGERT ON TRUSTS & TRUSTEES § 364; SCOTT ON TRUSTS § 372; *E. Kentucky Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1287-1288 (D.C. Cir. 1974), *vacated for plaintiffs' lack of standing*, 426 U.S. 26 (1976).

[6] Similar principles apply to educational and religious institutions, which also provide many services that directly benefit only their students or congregants. *See, e.g., Bethel*

Before revoking VSP's tax-exempt status in 2002, the IRS had long agreed with this position. In 1969, the IRS declared that the "promotion of health" is "one of the purposes in the general law of charity that is deemed beneficial to the community as a whole, *even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community*, ... provided that the class is not so small that its relief is not of benefit to the community." Rev. Rul. 69-545, 1969-2 C.B. 117 (emphasis added). This ruling made clear that a health care organization that serves a limited but broad class of subscribers, as most HMOs do, is engaged in a "charitable" purpose. The IRS's ruling was grounded in the common law of charitable trusts, and it accurately reflected that law. *See, e.g.*, RESTATEMENT §§ 368, 375. *See generally* Robert S. Bromberg, *The Charitable Hospital*, 20 CATH. U. L. REV. 237 (1970) (authored by the IRS lawyer who drafted Revenue Ruling 69-545).

2. The IRS granted VSP a tax exemption under 501(c)(4), which uses the term "social welfare," rather than 501(c)(3)'s "general law of charity." But this should have made no difference. Well-established law makes clear that the two sections are *in pari material*, and therefore must be construed together. *See generally Estate of Sanford v. Comm'r*, 308 U.S. 39, 44 (1939); *United States v. Freeman*, 44 U.S. 556, 564-565 (1845).[7] Consistent with this

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Conservative Mennonite Church v. Comm'r, 746 F.2d 388, 391 (7th Cir. 1984).

[7] "[T]he primary difference between the two ... is that organizations qualifying under § 501(c)(3) are restricted from substantial involvement in attempts to influence legislation, whereas § 501(c)(4) organizations have greater flexibility in

proposition, "[t]he IRS has a considerable propensity to import federal tax law principles applicable to tax-exempt charitable organizations to shape the law applicable to exempt social welfare organizations." THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 3 (2d ed. 2007 Cum. Supp.).[8]

Thus, the IRS has specifically recognized that 501(c)(4)'s "social welfare" organizations are a *broader* group than the "charitable" organizations of 501(c)(3). *See N. Calif. Central Servs., Inc. v. United States*, 591 F.2d 620, 625 (Ct. Cl. 1979). Indeed, the IRS typically has used section 501(c)(4) as a "convenient pigeonhole ... for organizations that, although worthy, failed to meet the particular requirements of other 501(c) subsections," especially "prepaid medical service organizations." IRS Gen. Couns. Mem. (G.C.M.) 34,709 (Dec. 7, 1971). *See generally* James J. McGovern, *Federal Tax Exemption of Prepaid Health Care Plans*, 7 TAX ADVISER 76 (1976).

Consistent with the common law and with the IRS understanding of the relationship between 501(c)(3) and 501(c)(4), the IRS for many years accepted nonprofit health care organizations such as

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that field." *N. Calif. Central Servs., Inc. v. United States*, 591 F.2d 620, 625 (Ct. Cl. 1979) (summarizing Government's position); *see also Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 546 (1983).

[8] Not in this case, however. Contrary to its earlier litigating position in *N. Calif. Central Servs., supra* n.7, in this case the Government has argued that cases involving exemption section 501(c)(3) are "inapposite"; and the district court agreed. App. 10-11a n.2. The Ninth Circuit did not address the issue.

VSP, the Blue Cross and Blue Shield organizations, and other HMOs as tax-exempt under 501(c)(4), and occasionally under 501(c)(3). *See* Otto Shill, *Revocation of Blue Cross & Blue Shield's Tax Exempt Status: An Unhealthy Change?*, 6 B.U. J. TAX L. 147, 150 (1988); *Developments in the Health Care Field: A Story of Dramatic Change*, at unnumbered p. 2, *in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR 1988, *at* www.irs.gov/pub/irs-tege/eotopicc88.pdf.

3. In 1986, Congress reviewed the tax-exempt status of health care companies in light of changes in the health care marketplace, particularly the increase in competitive, for-profit health insurers. As part of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, Congress adopted what is now Code section 501(m). This section denies a tax exemption under 501(c)(3) and 501(c)(4) to organizations that offer "commercial-type insurance."[9]

At the same time that it revoked tax exemptions for providers of "commercial-type insurance," however, Congress expressly retained the existing tax-exempt status for nonprofit HMOs, including HMOs offering supplemental services such as vision or dental plans. Section 501(m)(3)(B) thus provides that "commercial-type insurance" should *not* include "incidental health insurance provided by a health maintenance organization of a kind customarily

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[9] This provision was aimed specifically at the exemptions of the Blue Cross and Blue Shield organizations. *See, e.g.*, Shill, *supra*, at 147; H.R. REP. NO. 99-426, at 664 (1985), *reprinted in* 1986-3 C.B. (vol. 2), at 664.

provided by such organizations." The Conference Committee report explained:

> [O]rganizations that provide supplemental health maintenance organization-type services (such as dental services) are not affected [by section 501(m)] if they operate in the same manner as a health maintenance organization.

H.R. REP. NO. 99-841, at 345 (1986) (Conf. Rep.), *reprinted in* 1986-3 C.B. (vol. 4) 346.

Two years later, the Conference Report for the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3700, confirmed that Congress intended a "general exemption for health maintenance organizations," as well as for "organizations that provide supplemental ... services (such as dental or vision services) ... if they operate in the same manner as a health maintenance organization." H.R. REP. NO. 100-1104, at 9 (1988), *reprinted in* 1988-3 C.B. 473, 499.

Congress's judgment should have been determinative in this case. Instead, the Ninth Circuit's decision upholds the IRS's narrow (and erroneous) interpretation of section 501(c)(4) as excluding HMOs that do not provide "enough" additional public benefits. Such a reading would trump Congress's intent that section 501(m)(3) operate as a savings clause for nonprofit HMOs: Congress provided in section 501(m)(3) that HMOs that do *not* provide commercial-type health insurance are still eligible for tax-exempt status.

As this Court has previously made clear in the tax exemption context, the Ninth Circuit's interpretation of the Code is fundamental error. "[I]t is a basic principle of statutory construction that a specific statute, here subsection [501](e), controls over a general provision such as subsection [501](c)(3)." *HCSC-Laundry v. United States,* 450 U.S. 1, 6 (1981). This is "particularly" true when it is consistent with the legislative history and "when the two [provisions] are interrelated and closely positioned, both in fact being parts of § 501 relating to exemption of organizations from tax." *Id.* What was true of sections 501(c)(3) and 501(e) in *HCSC-Laundry* is true of sections 501(c)(4) and 501(m) in this case. The latter is the specific provision in which Congress expressed its intent that HMOs offering incidental health insurance, such as vision and dental care, should continue to be eligible for tax exemptions.

The IRS has deliberately ignored this congressional judgment. It has backed away from its prior ruling that a health care organization is eligible for tax-exempt status, "even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community." Quite to the contrary, the IRS has now proclaimed that it "do[es] not interpret [501(m)(3)(B)] as evidence of congressional intent to generally except HMOs from the proscription of IRS 501(m)(1)." John Francis Reilly et al., *IRC 501(c)(4) Organizations, in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR FY 2003, at I-33. But that is exactly what Congress intended, as both the statutory language and its legislative history make clear. *See* DOUGLAS M. MANCINO,

TAXATION OF HOSPITALS AND HEALTHCARE ORGANIZATIONS § 6.03 (2d ed. 2005).

The IRS's changed position – now condoned by the Ninth Circuit – makes it much more difficult for a nonprofit health care organization to qualify for an exemption under sections 501(c)(3) or 501(c)(4). Despite the fact that the basic mission of these organizations is a charitable one – the promotion of health care – the IRS now requires something more in the way of "community benefits" or "public benefits" in order to qualify for an exemption. *See, e.g.*, John M. Quirk, *Turning Back the Clock on the Health Care Organization Standard for Federal Tax Exemption*, 43 WILLAMETTE L. REV. 69, 76 (2007). This movement has been applauded by some[10] and criticized by others,[11] but both supporters and critics agree that the change has occurred. *See also* THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 165 (3d ed. 2007).

The decision below reflects the most extreme example yet of the IRS's change in position. The IRS has not contended in this litigation that VSP offers "commercial-type insurance," an offering that would bar exemption under section 501(m).[12] Instead, the

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[10] *See, e.g.*, John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29 (2005).

[11] *See, e.g.*, Douglas M. Mancino, *The Impact of Federal Tax Exemption Standards on Health Care Policy and Delivery*, 15 HEALTH MATRIX 5 (2005).

[12] The IRS did contend in the lower courts that VSP's "primary activity ... is carrying on a business with the general public in a manner similar to organizations which are operated for profit," Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii), and the District Court so found, App. 25a; but the Ninth Circuit expressly

IRS has wrongly sought to impose even more restrictive limits than section 501(m)(3) imposes. The IRS would limit the promotion of "social welfare" under section 501(c)(4) to organizations that are either not subscriber-based, or subscriber-based but provide "enough" additional community benefits. Despite its changed position, the IRS has not withdrawn Revenue Ruling 69-545, which is plainly inconsistent with its new position. *See* Douglas M. Mancino, *The Impact of Federal Tax Exemption Standards on Health Care Policy and Delivery*, 15 HEALTH MATRIX 5 (2005); Bromberg, *supra*. Nor has it promulgated regulations under section 501(m)(3) to explain or clarify its position. Rather, the IRS's new position introduces unwarranted and needless uncertainty and risk into the nonprofit health care sector and beyond, despite the absence of new legislation or regulation.

VSP fits squarely within section 501(m)(3)'s savings clause, *i.e.*, it is an HMO that does not offer commercial-type insurance. The IRS's more stringent interpretation of sections 501(m)(3) and 501(c)(4) is contrary to Congress's intent and the IRS's prior position granting tax exemptions to entities like VSP.

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declined to rest its decision on this basis. App. 3a. The subsequent congressional decision reflected in section 501(m) effectively supersedes the regulation, as it applies to nonprofit HMOs such as VSP. *See Chevron U.S.A. Inc. v. Natural Res. Defense Council*, 467 U.S. 837, 842-843 (1984) (legislative judgment controls).

II. VSP Is Exactly The Sort Of Nonprofit Organization That Congress Intended To Remain Tax-Exempt.

VSP is an HMO for federal tax purposes. "The defining feature of an HMO is receipt of a fixed fee for each patient enrolled under the terms of a contract to provide specified health care if needed." *Rush Prudential HMO, Inc. v. Moran*, 536 U.S. 355, 367 (2002). In the evolution of the health care industry, HMOs are moving away from the original staff or group model, in which services are rendered by employees or by a closely affiliated medical group, to what is referred to as a contract or network model, such as the one that VSP uses. *See generally U.S. Health Care, Inc. v. Healthsource, Inc.*, 986 F.2d 589, 591-592 (1st Cir. 1993) (describing evolution of HMOs from use of physician employees to use of contract physicians).

The IRS attempts to distinguish staff-model HMOs, which it describes as "providers," from contract-model HMOs such as VSP, which it disparages as mere "arrangers" of health-care services.[13] Section 501(m) makes no such distinction,

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[13] *See, e.g.*, Leah D. Embry Thompson & Robert K. Kolbe, *Federal Tax Exemption of Prepaid Health Care Plans After IRC 501(m)*, at unnumbered p. 16, *in* IRS EXEMPT ORGANIZATIONS, TECHNICAL INSTRUCTION PROGRAM FOR FY 1992, *at* www.irs.gov/pub/irs-tege/eotopicl92.pdf:

> The Service continues to hold that only HMOs that provide medical services, with only incidental insurance attributes, are covered by the IRC 501(m)(3)(B) exception. In all other cases, the insurance aspects outweigh the service aspects.

and the legislative history shows that none was intended.

Congress was well aware that HMOs take various forms. The Conference Committee report on the Tax Reform Act of 1986 observed:

> HMOs provide physician services in a variety of practice settings primarily through physicians who are either employees or partners of the HMO or through contracts with individual physicians or one or more groups of physicians (organized on a group practice or individual practice basis).

H.R. REP. NO. 99-841, *supra*, at 346. In the statute, Congress drew no distinction between "providers" and "arrangers," such as the one the IRS seeks to make.

The legislative history of section 501(m) is also explicit that supplementary vision and dental plans, of the sort provided by VSP, were the type of "incidental health insurance" Congress had in mind. *See id.*; STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 585-586.

Nor did Congress make HMOs' continued tax-exempt status depend on their provision of free care. Care offered substantially below cost is specified in section 501(m)(3)(A) as a separate exclusion from "commercial-type insurance." HMO-type organizations excluded under section 501(m)(3)(B) are not required also to satisfy the test of section 501(m)(3)(A).

The IRS's revocation of VSP's tax-exempt status, over 40 years after it was initially granted, represents an unauthorized departure from the established law of charitable trusts and from the specific judgment of the 1986 Congress, as well as from the IRS's own interpretation of section 501 expressed in Revenue Ruling 69-545. The IRS lacks any authority in legislation or in its own regulations for this departure.

III. It Is Vitally Important To A Large Sector Of The American Economy That The Question Presented Be Resolved Without Delay.

The uncertain state of tax exemptions for nonprofit health care organizations in general, and for HMOs in particular, is an area of "white-hot controversy." Travis L. Blais, *California Judge Makes Hash of Tax Exempt HMOs in Vision Service Plan*, 7 TAX & FINANCE 8-10 (Spring 2006) (newsletter of Tax & Finance Practice Group of American Health Lawyers Ass'n). "[T]he current state of the law in this area can only be characterized as incoherent." Richard L. Schmalbeck, *The Impact of Tax-Exempt Status: The Supply-Side Subsidies*, 68 LAW & CONTEMP. PROBS. 121, 129 (2006). "[N]onprofit health care organizations have entered an era of palpable uncertainty about what they must do to retain valuable exemptions." Quirk, *supra*, at 105.

The decisions below, although not published in the Thomson/West reports of federal decisions, have been closely followed by practitioners in the area. The revocation of VSP's tax exemption has been severely and correctly criticized as "inconsistent with clearly expressed congressional intent, recent

Supreme Court precedent, state regulatory schemes, and well-established IRS administrative practice." Christopher M. Jedrey & Charles R. Buck, *Health Care Organizations*, TAXATION OF EXEMPTS 280 (May/June 2006).

The conclusion reached by the courts below, that serving primarily fee-paying users precludes tax-exempt status, means "the loss of tax-exempt status for almost all currently tax-exempt HMOs. The implications of such an IRS position for hospital tax-exempt status also would be troubling." *Id.* at 282. Moreover, the Ninth Circuit's assertion that VSP's "public benefits" are "not enough" to qualify it for tax exemption, without any explanation or guidance as to what is "enough," or how it should be determined, only exacerbates the difficulty of tax planning for such organizations, and is plainly wrong.

The health care segment of the economy is critically important. In 2006 domestic health care spending amounted to $2.1 trillion, or $7,026 per person. Aaron Catlin et al., *National Health Spending in 2006: A Year of Change for Prescription Drugs*, 27 HEALTH AFFAIRS 1, 14 (2008). About half of the revenues in this portion of the economy are earned by nonprofit organizations. *See* BUREAU OF THE CENSUS, 2006 SERVICE ANNUAL SURVEY, NAICS 62, HEALTH CARE AND SOCIAL ASSISTANCE SERVICES Tables 8.1 & 8.5, *available at* http://www.census.gov/svsd/www/services/sas/sas_data/62/2006_NAICS62.pdf. Almost 90 percent of the revenues of these nonprofit health care organizations comes from the delivery of goods and services to those that they serve rather than from contributions. KENNARD T.

WING ET AL., THE NONPROFIT ALMANAC 2008, at 178 (The Urban Inst. 2008). The court of appeals' decision that there must be "enough" "public benefits" of an unspecified type to outweigh by some undefined measure the health care provided to paying patients, puts the tax-exempt status of all such organizations at risk.

Uncertainty about their tax-exempt status removes much of the incentive for these health care organizations to remain nonprofit. Conversion of such organizations to tax-paying, profit-maximizing status, as happened with many of the Blue Cross and Blue Shield organizations following the loss of their tax exemptions in 1986, has serious implications for the public health and welfare. Studies have repeatedly shown the superior quality of care provided through nonprofit HMOs compared to that provided through for-profit HMOs. *See* John P. Geyman, *The Corporate Transformation of Medicine and Its Impact on Costs and Access to Care*, 16 J. AM. BD. OF FAM. PRAC. 443, 444 (2003); David U. Himmelstein et al., *Quality of Care in Investor-Owned vs. Not-for-Profit HMOs*, 282 J.A.M.A. 159 (July 14, 1999); Robert Kuttner, *Must Good HMOs Go Bad? The Commercialization of Prepaid Health Care, Parts I and II*, 338 N.E.J.M. 1558, 1635 (May 21 & 28, 1998). *See also* Mark Schlesinger & Bradford H. Gray, *How Nonprofits Matter in American Medicine, and What To Do About It*, HEALTH AFFAIRS w287-w303 (June 2006) (superior performance of nonprofit hospitals and nursing homes).

CONCLUSION

The result below threatens established tax practice and congressional intent alike; and it jeopardizes the tax-exempt status of an important segment of the economy. The ruling that VSP's "public benefits" were "not enough" to justify a tax exemption for an HMO provides the industry with no guidance at all, where guidance is urgently required. The issues are clearly presented. The petition for a writ of certiorari should be granted.

Respectfully submitted,

Jeffrey L. Fisher
Douglas C. Ross
Marvin L. Gray, Jr.
DAVIS WRIGHT TREMAINE LLP
Suite 2200
1201 Third Avenue
Seattle, WA 98101
(206) 622-3150

Thomas A. Fessler
VISION SERVICE PLAN
3333 Quality Drive
Rancho Cordova, CA 95670
(916) 851-4889

Kenneth W. Starr
Counsel of Record
KIRKLAND & ELLIS LLP
777 South Figueroa St.
Los Angeles, CA 90017
(213) 680-8440

Susan E. Engel
KIRKLAND & ELLIS LLP
655 Fifteenth St., N.W.
Washington, DC 20005
(202) 879-5000

August 7, 2008

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United States Court of Appeals, Ninth Circuit.
VISION SERVICE PLAN, INC., Plaintiff-Appellant
v.
UNITED STATES of America, Defendant-Appellee.
No. 06-15269.

D.C. No. CV-04-01993-LKK.

Appeal from the United States District Court
for the Eastern District of California,
Lawrence K. Karlton, District Judge, Presiding.

Argued and Submitted
December 5, 2007
San Francisco, California

Filed Jan. 30, 2008.

Before: KOZINSKI, Chief Judge, COWEN,* and HAWKINS, Circuit Judges.

MEMORANDUM**

Vision Service Plan, Inc. ("VSP") appeals from the grant of summary judgment in favor of the United States on VSP's claim that it is a social welfare tax exempt organization pursuant to 26 U.S.C. § 501(c)(4).

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* The Honorable Robert E. Cowen, Senior United States Circuit Judge for the Third Circuit, sitting by designation.

** This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

VSP is not operated exclusively for the promotion of social welfare because it is not primarily engaged in promoting the common good and general welfare of the community. *See* 26 C.F.R. § 1.501(c)(4)-1(a)(2)(i) ("An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community."). While VSP offers some public benefits, they are not enough for us to conclude that VSP is *primarily* engaged in promoting the common good and general welfare of the community. *See, e.g., Monterey Pub. Parking Corp. v. United States,* 481 F.2d 175, 177 (9th Cir. 1973) (noting that the district court made a quantitative comparison between the private and public benefits); *see also Comm'r v. Lake Forest, Inc.,* 305 F.2d 814, 818 (4th Cir. 1962) (noting that the public benefits of organization were too insubstantial to qualify the organization as exempt under Section 501(c)(4)); *Police Benevolent Ass'n of Richmond v. United States,* 661 F. Supp. 765, 772-73 (E.D. Va.), *aff'd,* 836 F.2d 547 (4th Cir. 1987) (per curiam) (unpublished opinion). Furthermore, VSP's own articles of incorporation state that the primary purpose of the corporation is to establish a fund from payments by subscribers to defray and assume the costs of vision care for those subscribers. This is a purpose that benefits VSP's subscribers rather than the general welfare of the community. *See Contracting Plumbers Co-op. Restoration Corp. v. United States,* 488 F.2d 684, 686-87 (2d Cir. 1973) (setting forth several factors to examine in deciding whether an

organization qualifies for a Section 501(c)(4) exemption, including the bylaws of the organization).

In light of the fact that VSP is not primarily engaged in promoting the general welfare under 26 C.F.R. § 1.501(c)(4)-1(a)(2)(i), we need not address whether VSP carries on its business with the public in a manner similar to those organizations operated for profit.

AFFIRMED.

United States District Court, E.D. California.
VISION SERVICE PLAN, Plaintiff,
v.
UNITED STATES OF AMERICA, Defendant.
No. CIV. S-04-1993 LKK/JFM.

Dec. 12, 2005.

ORDER

KARLTON, Senior J.

In 1960, Vison Service Plan ("VSP") was granted status as a tax-exempt organization. In 1999, the IRS commenced an examination of VSP. The IRS concluded that VSP was not entitled tax-exempt status under Internal Revenue Code, 26 U.S.C., ("IRC"), Section 501(c)(4). Def.'s SUF, 1. The IRS issued a final adverse determination letter to VSP, revoking its IRC Section 501(c)(4) status, effective prospectively from January 1, 2003. Def.'s SUF, 2. The following year, VSP paid the tax owed on its 2003 earnings, and then filed this suit.

Pending before the court are cross-motions for summary judgment. VSP seeks a determination that it is a social welfare organization under 501(c)(4), a refund of its income tax payment for 2003 and an order that the United States issue it a private letter recognizing VSP's status under 501(c)(4). The United States seeks summary judgment on the grounds that VSP does not qualify for exemption under 501(c)(4).

II.

STANDARDS

Summary judgment is appropriate when it is demonstrated that there exists no genuine issue as to any material fact, and that the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c); *See also Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157 (1970); *Sicor Limited v. Cetus Corp.*, 51 F.3d 848, 853 (9th Cir. 1995).

Under summary judgment practice, the moving party

> [A]lways bears the initial responsibility of informing the district court of the basis for its motion, and identifying those portions of "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any," which it believes demonstrate the absence of a genuine issue of material fact.

Celotex Corp. v. Catrett, 477 U.S. 317, 323 (1986). "[W]here the nonmoving party will bear the burden of proof at trial on a dispositive issue, a summary judgment motion may properly be made in reliance solely on the 'pleadings, depositions, answers to interrogatories, and admissions on file.'" *Id.* Indeed, summary judgment should be entered, after adequate time for discovery and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of

proof at trial. *See id.* at 322. "[A] complete failure of proof concerning an essential element of the nonmoving party's case necessarily renders all other facts immaterial." *Id.* In such a circumstance, summary judgment should be granted, "so long as whatever is before the district court demonstrates that the standard for entry of summary judgment, as set forth in Rule 56(c), is satisfied." *Id.* at 323.

If the moving party meets its initial responsibility, the burden then shifts to the opposing party to establish that a genuine issue as to any material fact actually does exist. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986); *See also First Nat'l Bank of Ariz. v. Cities Serv. Co.*, 391 U.S. 253, 288-89 (1968); *Sicor Limited*, 51 F.3d at 853.

In attempting to establish the existence of this factual dispute, the opposing party may not rely upon the denials of its pleadings, but is required to tender evidence of specific facts in the form of affidavits, and/or admissible discovery material, in support of its contention that the dispute exists. Fed. R. Civ. P. 56(e); *Matsushita*, 475 U.S. at 586 n. 11; *See also First Nat'l Bank*, 391 U.S. at 289; *Rand v. Rowland*, 154 F.3d 952, 954 (9th Cir. 1998). The opposing party must demonstrate that the fact in contention is material, i.e., a fact that might affect the outcome of the suit under the governing law, *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986); *Owens v. Local No. 169, Assoc. of Western Pulp and Paper Workers*, 971 F.2d 347, 355 (9th Cir. 1992) (quoting *T.W. Elec. Serv., Inc. v. Pacific Elec. Contractors Ass'n*, 809 F.2d

626, 630 (9th Cir. 1987), and that the dispute is genuine, i.e., the evidence is such that a reasonable jury could return a verdict for the nonmoving party, *Anderson,* 477 U.S. 248-49; *see also Cline v. Industrial Maintenance Engineering & Contracting Co.,* 200 F.3d 1223, 1228 (9th Cir. 1999).

In the endeavor to establish the existence of a factual dispute, the opposing party need not establish a material issue of fact conclusively in its favor. It is sufficient that "the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial." *First Nat'l Bank,* 391 U.S. at 290; *See also T.W. Elec. Serv.,* 809 F.2d at 631. Thus, the "purpose of summary judgment is to 'pierce the pleadings and to assess the proof in order to see whether there is a genuine need for trial.'" *Matsushita,* 475 U.S. at 587 (quoting Fed. R. Civ. P. 56(e) advisory committee's note on 1963 amendments); *see also International Union of Bricklayers & Allied Craftsman Local Union No. 20 v. Martin Jaska, Inc.,* 752 F.2d 1401, 1405 (9th Cir. 1985).

In resolving the summary judgment motion, the court examines the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any. Rule 56(c); *See also In re Citric Acid Litigation,* 191 F.3d 1090, 1093 (9th Cir. 1999). The evidence of the opposing party is to be believed, *see Anderson,* 477 U.S. at 255, and all reasonable inferences that may be drawn from the facts placed before the court must be drawn in favor of the opposing party, *see Matsushita,* 475 U.S. at 587 (citing

United States v. Diebold, Inc., 369 U.S. 654, 655 (1962) (*per curiam*)). Nevertheless, inferences are not drawn out of the air, and it is the opposing party's obligation to produce a factual predicate from which the inference may be drawn. *See Richards v. Nielsen Freight Lines*, 602 F. Supp. 1224, 1244-45 (E.D. Cal. 1985), *aff'd*, 810 F.2d 898, 902 (9th Cir. 1987).

Finally, to demonstrate a genuine issue, the opposing party "must do more than simply show that there is some metaphysical doubt as to the material facts. . . . Where the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party, there is no 'genuine issue for trial.'" *Matsushita*, 475 U.S. at 587 (citation omitted).

III.

ANALYSIS

The issue to be resolved in the cross-motions is whether VSP qualifies for tax exempt status under 26 U.S.C. § 501(c)(4). Below, I explain why plaintiff's motion for summary judgment must be denied and defendant's motion for summary judgment must be granted.

A. APPLICABLE LAW[1]

A taxpayer seeking exemption from taxation has the burden of proving by clear and convincing proof that he is within a specific exemption clause. *Club Gaona, Inc. v. United States,* 167 F. Supp. 741, 746 (S.D. Cal. 1958).

Section 501(c)(4) of the Internal Revenue Code (26 U.S.C.A. § 501(c)(4)) provides federal tax exemption to a social welfare organization. Section 501 provides, in pertinent part, that "organizations not organized for profit but operated exclusively for the promotion of social welfare" shall be exempt from taxation. 26 U.S.C. §§ 501(a) and 501(c)(4)(A).

Although the words "exclusively" and "primarily" have different meanings, courts interpret the word "exclusively" to mean, "primarily." *See American Women Buyers Club, Inc. v. United States,* 338 F.2d 526, 528 (2nd Cir. 1964) ("The word 'exclusively' as used in the statute has not been given a strict interpretation . . . but rather has been interpreted to mean 'primarily.'") (citing *Debs Memorial Radio Fund, Inc. v. Commissioner,* 148 F.2d 948, 952 (2nd Cir. 1945)).

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[1] Because resolution of these motions require a fact-intensive inquiry, the court will eschew a separate exposition of the facts. The facts discussed during the analysis section are undisputed, unless indicated otherwise.

In like fashion, the regulations provide:

> An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

26 C.F.R. § 1.501(c)(4)-1(a)(2).

The regulations go on to provide that an organization is not operated primarily for the promotion of social welfare if its primary activity is "carrying on a business with the general public in a manner similar to organizations which are operated for profit." 26 C.F.R. § 1.501(c)(4)-1(a)(2)(ii).

In essence, VSP must establish that it is (1) not organized for profit; and (2) that it operates primarily for the promotion of social welfare. 26 C.F.R. § 1.501(c)(4)-1(a)(I) & (ii). As I explain below, VSP is unable to demonstrate satisfaction of either of the two requisite criteria.[2]

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[2] Defendant places great reliance of [sic] cases addressing qualification for tax exempt status under § 501(c)(3). That reliance is inapposite. Section 501(c)(3) and (c)(4) address different circumstances and have different criteria for exemption. Moreover, the three 503(c)(3) cases discussed by VSP are distinguishable as they involve actual health care providers or

(Continued on following page)

B. THE PROMOTION OF SOCIAL WELFARE

Plaintiff maintains that it qualifies for exemption under 501(c)(4) because "it is operated primarily for the promotion of social welfare." Pl.'s Mot. for Summ. J. at 2:20. VSP claims to serve broad segments of the community through direct services as well as through charity work. While VSP's charitable work is admirable, VSP cannot establish that it operates primarily for the promotion of social welfare within the meaning of the tax regulations.

The Treasury regulation provides that:

> An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

26 C.F.R. § 1.501(c)(4)-1(a)(2).

Thus, to qualify an organization must be "a community movement designed to accomplish community ends." *Erie Endowment v. United States*, 316 F.2d 151, 156 (3d Cir. 1962).

It is frequently the case that an organization is found not to qualify under 501(c)(4) because it is operating primarily for the benefit of its members, rather than for the purpose of benefitting the community as a whole. *See, e.g., Contracting Plumbers*

HMOs. As discussed in the text, plaintiff is not a health care provider.

Co-op. Restoration Corp. v. United States, 488 F.2d 684, 686 (2d Cir. 1973) (plumbers cooperative not tax exempt as benefits were proportional to member's financial involvement); *American Women Buyers,* 338 F.2d at 528 (association not tax exempt as majority of benefits were for members and did not promote social welfare). In sum, where organizations provide substantially different benefits to the public as compared to its private members, it is not "primarily" devoted to social welfare as required by Section 501(c)(4). *Id.* at 687. In essence, even though there may be aspects of the organization that greatly benefit society, if the majority of the organization's services benefit private members, the organization cannot qualify for an exemption under 501(c)(4). Moreover, it has also been held that "[t]he presence of a single substantial non-exempt purpose precludes exempt status regardless of the number or importance of the exempt purpose." *Contracting Plumbers,* 588 F.2d at 686. Finally, it is pertinent to the instant case to note that the fact that an organization promotes health care, or is part of the health care industry, does not, alone, ensure exempt status within the tax code. *See IHC Health Plans Inc. v. Commissioner of Internal Revenue,* 325 F.3d 1188, 1197 (10th Cir. 2003).

The test for qualification under 501(c)(4) is stringent. For instance, in *Commissioner of Internal Revenue v. Lake Forest, Inc.,* 305 F.2d 814 (4th Cir. 1962), the court found that a membership-based organization involved in providing housing for veterans did not qualify. The court explained:

> Lake Forest does, of course, furnish housing to a certain group of citizens but it does not do so on a community basis. It is a public-spirited but privately-devoted endeavor. Its work in part incidentally redounds to society but this is not the 'social welfare' of the tax statute.

C.I.R. v. Lake Forest, Inc., 305 F.2d at 818. The court further explained that classification as "'civic' or 'social' depends upon the character – as public or private – of the benefits bestowed, of the beneficiary, and of the benefactor." *Id.*

As applied to the case at bar, the court concludes that despite VSP's charity work, the membership-based structure as well as the types of services offered, demonstrate that VSP's primary activity is not the promotion of social welfare. I begin this part of the analysis with an examination of VSP's service structure.

1. *VSP's Clients*

Plaintiff argues that VSP serves a broad cross section of the California community. *See* Pl.'s Mot. for Summ. J. at 27:12-16. While this may be true, VSP's primary activity is to defray and assume "the costs of professional vision care by establishing a fund from periodic payments by subscribers or beneficiaries, from which fund said costs may be paid." Decl. of Jeremy N. Hendon, Ex. A, VSP's Articles of Incorporation, at Article II. VSP contracts with employers,

health maintenance organizations, insurance companies, and political subdivisions ("subscribers") to arrange for the provision of vision care services and vision supplies to the subscribers' employees or members ("enrollees"). Def.'s SUF, 3.

VSP provides services to subscribers and through them, to enrollees. A non-enrolled individual may not simply walk in off the street to receive care. Def. SUF, 6. Although VSP does provide services through charity programs, these services to non-enrollees are not, comparatively, substantial. Much like the organizations at issue in *Lake Forest* or *Contracting Plumbers Cooperative,* the benefits that VSP provides to the public are incidental and not the primary purpose of VSP. VSP's primary purpose is to serve VSP's paying members.

VSP argues that there are several factors favoring a finding of tax exempt status. They note that (1) many of VSP's subscribers are small businesses, a consideration under the Internal Revenue Manual in evaluating tax exempt status, Pl.'s SUF 27; (2) many VSP doctors serve areas designated as medically needy or under served. Pl.'s SUF, 90-91.; (3) VSP provides vision care for many Medicaid and Medicare participants; and (4) VSP services low income children through the California Healthy Families Child Health Assistance Program ("Healthy Families"), Pl.'s SUF, 30. The court now addresses each of these contentions.

a. *Small Employers & Servicing Rural Areas*

Servicing small employers or rural subscribers and enrollees does not equate to promoting social welfare. *See* Def. Opp'n at 24: 14-22. Small employers or rural employers are still paying for VSP's services and VSP is making a profit from these contracts. VSP submits that the Internal Revenue Manual lists servicing smaller employers and rural enrollees as a factor in determining if an HMO qualifies for exemption under 501(c)(4). *See* Pl.'s Mot. for Summ. J. 27:20-22. This argument is unavailing. Even assuming arguendo the binding character of the manual, a dubious proposition, VSP is not an HMO, i.e. it does not provide medical services, it is instead what is known in the trade as a bundler.[3]

b. *Medicaid, Medicare and Healthy Families enrollees*

VSP argues that servicing Medicaid, Medicare and Healthy Families participants is a central part of how VSP promotes social welfare.

In 2003, VSP covered more than 2.1 million Medicaid and Medicare participants for vision care. These enrollees comprised 31.4% of VSP's total enrollment. Pl.'s SUF, 29. Combined with the children VSP served through Healthy Families, these three

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[3] There is nothing pejorative in the term, it simply notes a functional difference between providers, and an organization that arranges for the provision of services.

groups of enrollees represented 41.5% of VSP's total enrollment in 2003. VSP submits that it suffered substantial losses from providing services to Medicaid, Medicare and Healthy Families participants. *See* Pl.'s SUF, 35. VSP argues that these facts support a finding that VSP is primarily engaged in promoting social welfare. The court cannot agree.

First, VSP competitively bid for the Medicaid, Medicare and Healthy Families contracts. *See* Def.'s Mot. for Summ. J., Hendon Dec., Ex. H at 137-41. As defendant notes:

> The criterion for an Enrollee to receive VSP's services is not whether such person is a member of a medically underserved population. Rather, the criterion is whether the Enrollee is an employee or member of a paying Subscriber (e.g., the State of California) which contracts with VSP for a fee. That is, VSP does not focus on individuals who need medical care, but focuses on its Subscribers with whom VSP contracts for a fee.

Def. Mot. for Summ. J. at 11:15-19.

Second, in calculating the alleged losses, VSP includes discounts given by participant doctors. This does not appear appropriate. As the court understands it, the providing doctor incurs the loss and not VSP.[4] Therefore, the court does not accept as accurate

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[4] Defendant's example is helpful in understanding how it is that VSP does not absorb the loss:

(Continued on following page)

the alleged "losses" as calculated by plaintiff. *See* Pl. Mot. for Summ. J., Cochran Dec., Ex. K.

Third, from all that appears, the Medicaid, Medicare and Healthy Families programs are profitable for VSP. As defendant maintains, if VSP refused to reduce its fees for these contracts, "VSP would lose a substantial volume of business, albeit at reduced fees." Def.'s Opp'n to Pl. Mot. for Summ. J. at 27:23-26.

Fourth, VSP claims that in 2003, excluding doctor discounts, VSP spent $4,296,055.00 on discounts and underwritten losses for Medicare, Medicaid and Healthy Families participants. Pl's. Mot. for Summ. J., Cochran Dec. Ex. N. Even if the court accepts VSP's numbers as accurate, this expenditure of $4,296,055.00 is a relatively small fraction of VSP's net income for 2003, which was $34,487,626.00, *id.*, and an even smaller fraction of VSP's gross income

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> For example, suppose the customary doctor fee was $100 per patient and the reduced doctor fee for Subscribers with Medicare enrollees was $75 per patient; VSP does not suffer a $25 loss because, while it receives $75 per patient from the Subscriber, it is required to pay the doctor provider only $75 per patient, not $100. Thus, there is no net "loss" to VSP. The doctor is the only participant who arguably suffers a "loss."

Def. Opp'n at 27:15-19.

Moreover, even there the "loss" suffered by the provider is only as compared to his usual fee.

for 2003, which was $425 million. Def.'s Mot. for Summ. J., Hendon Dec., Ex. K.

Even if the court concluded that servicing these specific enrollees could constitute promoting social welfare, these enrollees make up less than half of VSP's total enrollment, thus again negating a conclusion that VSP is "primarily engaged" (much less exclusively engaged) in promoting social welfare.

While VSP does in fact offer services to these groups, it is also very clear that servicing these particular enrollees is not VSP's primary activity. Put directly, VSP is operating primarily for the benefit of its subscribers rather than for the purpose of benefitting the community as a whole. This conclusion precludes VSP from exemption under 501(c)(4). *See, e.g., Contracting Plumbers,* 488 F.2d at 686; *American Women Buyers Club,* 338 F.2d at 528.

2. *VSP's Charity Services*

Plaintiff maintains that VSP provides free vision care to "substantial numbers of non-enrollees under VSP's charity programs." Pl.'s SUF, 23. It is true that VSP provides vision care services to non-enrollees. Nonetheless, the provision of these services is comparatively small, and again, does not establish that VSP is primarily engaged in promoting social welfare.

There are two main programs through which non-enrollees might receive vision care services: the Sight for Students program and disaster relief efforts.

a. *Sight for Students*

This program targets children of families earning up to 200% of the poverty level and who do not participate in other eyecare insurance programs. VSP's free services under the program include eye examinations, eyeglasses, medically-necessary contact lenses, vision therapy and low vision treatment. These services are available for students up to age 18 or through graduation from high school. Pl.'s SUF, 37. The Sight for Students children and their families select a VSP doctor and present a VSP service authorization (voucher). The VSP doctor then provides services and is paid standard VSP contract rates by VSP or a local VSP affiliate. VSP or an affiliate bears the cost of the providers' services and of the glasses or contacts provided under the plan. Pl.'s SUF, 39.

In 2003, VSP spent $2.8 million dollars on this program, Pl.'s Mot. for Summ. J., Cochran Dec., Ex. N, and provided services for 12,558 children. *Id.*, Ex. H. When one compares $2.8 million, however, with VSP's net or gross income, it appears that the amount spent on this program is not substantial. Indeed, children receiving care under the Sight for Students program constituted only .19% of VSP's total enrollment. Taken together, these facts support a finding that VSP is not primarily engaged in the promotion of social welfare.

b. *Disaster Relief Services*

In conjunction with the American Red Cross, VSP also contributes to disaster relief by providing free exams and replacement glasses to disaster victims. VSP provides vouchers to chapters of the American Red Cross for free services. Disaster victims may present these authorizations to VSP providers to receive free examinations and glasses, for which VSP reimburses the providers. Pl.'s SUF, 41.

In 2003, VSP provided services for 285 people compared to a total enrollment of 6 million, Pl.'s Mot. for Summ. J., Cochran Dec., Ex. H, and spent roughly $73,132.00. *Id.* Again, compared to either VSP's net income or gross income, the amount spent on disaster relief services is minimal.

3. *VSP's Community Outreach and Community Education*

In addition to providing services to non-enrollees, VSP also engages in educational and community outreach. These programs include: (1) Get Focused Campaign; (2) Health Care Vision Project; (3) Vision USA; (4) Eye on Health Patient Newsletter; (5) Optometric Education and Research; (6) Clinical Guidelines and Algorithms; and (7) Paid Time Off for Volunteer Service. See Pl.'s Mot. for Summ. J. at 34-36. VSP claims that these programs, in conjunction with the services provided to Medicaid, Medicare and Healthy Families participants, support a finding that

it is primarily engaged in the promotion of social welfare. The court cannot agree.

While these programs are admirable and important, they do not demonstrate VSP being primarily involved in the promotion of social welfare. In 2003, VSP spent $3,893,496.00 on these programs. *See* Pl.'s Mot. for Summ. J., Cochran Dec., Ex N. This includes the Sight for Students Program, as well as disaster relief services. Again, this is a very small fraction of VSP's gross or net income for 2003.

Plaintiff submits that, taken together, VSP's charity work and service to Medicaid, Medicare and Healthy Families participants demonstrates that VSP should be exempt under the requirements of 501(c)(4). VSP's own numbers do not support such a conclusion.

In 2003, VSP spent roughly 8 million dollars on charity work. *See* Pl.'d Mot. for Summ. J., Cochran Decl., Ex. N. This number does not include doctor discounts, but does include the costs that VSP allegedly incurred providing services to Medicaid, Medicare and Healthy Families participants.

Even assuming that VPS's calculations are accurate, eight million dollars is 24% of VSP's 2003 net income and an even smaller percentage of VSP's gross income. In sum, these programs and services do not demonstrate that VSP is primarily engaged in the promotion of social welfare. While VSP does contribute to the betterment of society, like the organization in *Lake Forest,* it is a "publicly spirited but

privately-devoted endeavor." *Lake Forest,* 305 F.2d at 818. VSP's work "incidentally redounds to society but this is not the 'social welfare' of the tax statute." *Id.*

Put directly, the court must conclude that VSP's services are most beneficial to private paying members, the subscribers and the enrollees. Like the members of the plumbers cooperation in *Contracting Plumbers,* members of VSP enjoy the benefit of VSP's services precisely to the extent that members use and pay for the services. *Contracting Plumbers,* 488 F.2d at 687. Serving the interests of these private subscribers is clearly a non-exempt purpose. *Id.* This non-exempt purpose destroys VSP's exemption status, regardless of the number or importance of truly exempt purposes. *Id.*; *American Women Buying Club,* 338 F.2d at 528.

C. NOT OPERATING FOR PROFIT

Plaintiff submits that VSP was organized as a non-profit and operates like one. VSP points to its by-laws, which provides in pertinent part:

> This Corporation shall operate as a nonprofit corporation and shall be organized and operated exclusively for the promotion of social welfare within the meaning of Section 501(c)(4) of the Internal Revenue Code of 1986, as amended, or any successor provision. The Corporation shall maintain and operate a voluntary nonprofit vision care plan to provide care to subscribers to such plan under contracts which entitle the subscribers

> to certain eye care; to provide eye care to medically underserved persons, whether or not subscribers to such plan; to provide public education regarding vision and vision care; to perform such services in a manner that benefits the community; and to engage in any and all lawful activities necessary and incidental thereto.

Pl.'s SUF, 3.

The issue, however, is not whether plaintiff is a nonprofit corporation for corporation law purposes, but whether it is one for federal tax purposes.

To qualify for an exemption under 501(c)(4), an organization must establish that it operates exclusively for the promotion of social welfare. According to the Treasury regulations, an organization is not operated primarily for the promotion of social welfare if its primary activity is "carrying on a business with the general public in a manner similar to organizations which are operated for profit." 26 C.F.R. § 1.501(c)(4)-1(a)(2)(ii). Moreover, a corporation that devotes much of its revenues to improving its ability to compete commercially through accumulation of large surpluses and expansion of its income producing facilities is not entitled to exemption under Section 501(c)(4). *People's Educational Camp Soc. Inc. v. C.I.R.*, 331 F.2d 923, 932 (2d Cir. 1964).

In this regard, I begin by noting that VSP engages in cost-cutting measures common to for-profit businesses. For example, a portion of VSP's bonus

structure paid to its employees is directly tied to reducing VSP's costs. Def.'s SUF, 24. *See also* Def.'s SUF, 25 and 26 (discussing other ways that VSP cuts costs).

Second, VSP strives to remain competitive in ways that do not appear to be consistent with the operations of a non-profit. For example, VSP pays commissions to brokers who bring new clients. In 2003, VSP paid $19 million in broker commissions. (This is more than VSP spent on charity work in 2003, Pl.'s Mot. for Summ. J., Cochran Dec., Ex. N). The broker's commission is calculated based on the revenue that VSP receives from each new client. Def.'s SUF, 29. *See also* Def.'s SUF, 30-31.

Moreover, the court is unable to agree with plaintiff that no one profits from its activities. Although VSP's by-laws provide that VSP has no equity owners who are entitled to share in its net earnings, in fact VSP executives and officers receive bonuses that are taken directly from the net earnings. *See* Def.'s Resp. to Pl.'s SUF, 4 (discussing VSP executive bonuses and how bonuses are calculated). Furthermore, VSP offers its executives high salaries and other forms of compensation that are more consistent with a for-profit corporation than an [sic] non-profit. For example, Roger Valine, the Chief Executive Officer of VSP, although not required to work full time, was paid a $395,000 base salary for 2003, in addition to a sizable bonus plan. Def.'s SUF, 37 & 44. Chief officers and executives are also provided with luxury company cars. *See* Def.'s SUF, 47-49. VSP

specifically targeted the executives' salaries to median market levels, making no distinction between salaries paid to executives working at for-profit businesses, and executives working at non-profit entities. Def.'s SUF, 38. *See also* Def.'s SUF, 40-41; 47-49 (describes other ways that executives are compensated).

The court concludes that VSP carries on business with the public "in a manner similar to organizations which are operated for profit." 26 C.F.R. § 1.501(c)(4)-1(a)(2)(ii). Therefore, VSP does not operate primarily for the promotion of social welfare.

D. CONCLUSION

Plaintiff has failed to establish that it qualifies for exempt status under 501(c)(4). VSP is not operated "exclusively for the promotion of social welfare" as provided for in 501(c)(4). For these reasons, summary judgment for the defendant, United States, is GRANTED. Summary judgment for the plaintiff, VSP, is DENIED. The Clerk is directed to ENTER judgment accordingly and CLOSE the case.

IT IS SO ORDERED.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

VISION SERVICE PLAN, INC., Plaintiff-Appellant, v. UNITED STATES OF AMERICA, Defendant-Appellee.	No. 06-15269 D.C. No. CV-04-01993-LKK Eastern District of California, Sacramento ORDER (Filed Apr. 9, 2008)

Before: KOZINSKI, Chief Judge, COWEN,* and HAWKINS, Circuit Judges.

The panel has voted to deny the petition for rehearing. Chief Judge Kozinski and Judge Hawkins have voted to deny the petition for rehearing en banc. Judge Cowen has recommended denying the en banc petition.

The full court has been advised of the petition for rehearing en banc and no Judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing and petition for rehearing en banc are DENIED.

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* The Honorable Robert E. Cowen, Senior United States Circuit Judge for the Third Circuit, sitting by designation.

26 U.S.C. §§ 501(a), 501(c)(3)-(4), and 501(m)

(a) Exemption from taxation. – An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503

. . .

(c) List of exempt organizations. – The following organizations are referred to in subsection (a):

. . .

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

(4)(A) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(B) Subparagraph (A) shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

. . .

(m) Certain organizations providing commercial-type insurance not exempt from tax. –

(1) Denial of tax exemption where providing commercial-type insurance is substantial part of activities. – An organization described in paragraph (3) or (4) of subsection (c) shall be exempt from tax under subsection (a) only if no substantial part of its activities consists of providing commercial-type insurance.

(2) Other organizations taxed as insurance companies on insurance business. – In the case of an organization described in paragraph (3) or (4) of subsection (c) which is exempt from tax under subsection (a) after the application of paragraph (1) of this subsection –

(A) the activity of providing commercial-type insurance shall be treated as an unrelated trade or business (as defined in section 513), and

(B) in lieu of the tax imposed by section 511 with respect to such activity, such organization shall be treated as an insurance company for purposes of applying subchapter L with respect to such activity.

(3) Commercial-type insurance. – For purposes of this subsection, the term "commercial-type insurance" shall not include –

(A) insurance provided at substantially below cost to a class of charitable recipients,

(B) incidental health insurance provided by a health maintenance organization of a kind customarily provided by such organizations,

(C) property or casualty insurance provided (directly or through an organization described in section 414(e)(3)(B)(ii)) by a church or convention or association of churches for such church or convention or association of churches,

(D) providing retirement or welfare benefits (or both) by a church or a convention or association of churches (directly or through an organization described in section 414(e)(3)(A) or 414(e)(3)(B)(ii)) for the employees (including employees described in section 414(e)(3)(B)) of such church or convention or association of churches or the beneficiaries of such employees, and

(E) charitable gift annuities.

(4) Insurance includes annuities. – For purposes of this subsection, the issuance of annuity contracts shall be treated as providing insurance.

(5) Charitable gift annuity. – For purposes of paragraph (3)(E), the term "charitable gift annuity" means an annuity if –

(A) a portion of the amount paid in connection with the issuance of the annuity is allowable as a deduction under section 170 or 2055, and

(B) the annuity is described in section 514(c)(5) (determined as if any amount paid in cash in connection with such issuance were property).

Treasury Regulation § 1.501(c)(4)(1)

(a) Civic organizations – (1) In general. A civic league or organization may be exempt as an organization described in section 501(c)(4) if –

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) Promotion of social welfare – (i) In general. An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for

the purpose of bringing about civic betterments and social improvements. A social welfare organization will qualify for exemption as a charitable organization if it falls within the definition of charitable set forth in paragraph (d)(2) of § 1.501(c)(3)-1 and is not an action organization as set forth in paragraph (c)(3) of § 1.501(c)(3)-1.

(ii) Political or social activities. The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit. See, however, section 501(c)(6) and § 1.501(c)(6)-1, relating to business leagues and similar organizations. A social welfare organization that is not, at any time after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3) may qualify under section 501(c)(4) even though it is an action organization described in § 1.501(c)(3)-1(c)(3)(ii) or (iv), if it otherwise qualifies under this section. For rules relating to an organization that is, after October 4, 1976, exempt from taxation as an organization described in section 501(c)(3), see section 504 and § 1.504-1.

(b) Local associations of employees. Local associations of employees described in section 501(c)(4) are expressly entitled to exemption under section 501(a). As conditions to exemption, it is

required (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. The word local is defined in paragraph (b) of § 1.501(c)(12)-1. See paragraph (d)(2) and (3) of § 1.501(c)(3)-1 with reference to the meaning of charitable and educational as used in this section.